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97TH CONGRESS
2d Session

SENATE

REPORT
No. 97-640

SUBCHAPTER S REVISION ACT OF 1982

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 6055

SEPTEMBER 29 (legislative day, SEPTEMBER 8), 1982.—Ordered to be printed

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Mr. DOLE, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 6055]

The Committee on Finance, to which was referred the bill (H.R. 6055) to revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations), having considered the same, reports favorably thereon with amendments and recommends that the bill as amended to pass.

The amendments are shown in the test of the bill in italic.

I. SUMMARY

In general, the Subchapter S Revision Act of 1982 is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This is accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes from present law made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the bill makes the following changes:

(1) The number of permitted shareholders will be increased from 25 to 35;

(2) Differences in voting rights in common stock will not violate the one-class-of-stock requirement;

(3) The present law rule which results in the termination of an election if the corporation derives more than 80 percent of its gross receipts from sources outside the United States will be repealed;

(4) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year is passive investment income will be eliminated for corporations which do not have accumulated earnings and profits from regular corporate years at the close of the taxable year, and will be substantially modified for corporations with accumulated earnings and profits in order to reduce the likelihood of a termination; and

(5) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status will not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder will be bound by the initial election until the election is otherwise terminated.

Elections, revocations and terminations

The bill provides that an election made on or before the fifteenth day of the third month of the taxable year will be effective from the beginning of the taxable year if all persons who held stock in the corporation during the pre-election portion of that year were individuals, estates, and qualified trusts, and if all persons who held stock in the corporation at any time during the year up to the time the election is made consent to the election. If these requirements are not met, or if the election is made later than the fifteenth day of the third month of the taxable year, it will not be effective until the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of an eligible corporation will terminate the election as of the day on which the event occurred (rather than as of the first day of the taxable year in which the event occurred, as under present law). To minimize the effect of an inadvertent termination, the bill provides that the Internal Revenue Service may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

The bill provides that an election can be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule which requires all shareholders to consent to a revocation). The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year is modified so that such a retroactive revocation may be filed on or before the fifteenth day of the third month of the taxable year.

Passthrough of income, etc.

The bill provides that the character of items of income, deduction, loss, and credits of the corporation will pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to partners. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, the source or allocation of foreign income or loss, and foreign income taxes will pass through and retain their character in the hands of shareholders.

As is the case under present law with respect to losses, income will be passed through and allocated to shareholders on a per-share, per-day basis.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships will apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a subchapter S election will be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department. These rules also apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, can continue its current taxable year so long as 50 percent or more of the outstanding stock in the corporation on that date continues to be owned by the same shareholder. For purposes of this transitional rule, transfers to stock pursuant to certain existing agreements, by gift to family members, or by reason of death will not be considered changes in ownership.

Carryforward of loss

Under the bill, a subchapter S shareholder will be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the basis in his or her subchapter S stock and loans to the corporation. The loss carried forward can be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distributions

The rules relating to distributions from subchapter S corporations are extensively revised.

Under the new rules, a corporation will not have earnings and profits attributable to any taxable year beginning after the date of enactment if a subchapter S election is in effect for that year. For corporations with no earnings and profits, the amount of the distribution (generally cash plus the fair market value of property) will be tax-free and will reduce the shareholder's basis in his or her stock. To the extent that the amount of the distribution exceeds the amount of the basis in the stock, capital gains generally will result.

For corporations with accumulated earnings and profits, the distribution will be treated as a distribution by a corporation without earnings and profits to the extent of the shareholder's portion of the undistributed amount of subchapter S gross income less deductible expenses (an "accumulated adjustment account"). Any amount in excess of the accumulated adjustment account will be treated under the usual corporate rules, first as a distribution out of accumulated earnings and profits to the extent thereof.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses, respectively, will serve to increase and decrease the subchapter S shareholder's basis in his or her stock of, and loans to, the corporation. These rules are generally analogous to those provided for partnerships. Also, unlike present law, basis will be restored to debt obligations as well as to stock. Restoration of basis will be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain will be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

Fringe benefits

Under the bill, rules similar to the partnership tax rules will apply to employee fringe benefits. For this purpose, persons owning two percent or more of the corporate stock will be treated as partners.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning two percent or more of the corporation's stock will be deductible only when paid.

Administration

The bill provides that the items of subchapter S income, deductions, and credits will be determined in audit and judicial proceedings at the corporate level rather than separately with each shareholder. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation.

Effective date

The bill generally will be effective for taxable years beginning after December 31, 1982.

II. REASONS FOR CHANGE

For tax purposes, a corporation generally is treated as a separate entity apart from its shareholders. That is, income earned by the corporation is taxed to it, and distributions from the corporation (either as dividends or in liquidation) also are taxed to the shareholders. A partnership, on the other hand, is not treated as a taxable entity for income tax purposes. Instead, the income of the partnership, whether distributed or not, is taxed to the partners, and distributions by the partnership are generally tax-free.

In many instances, businesses, especially small businesses, may wish to incorporate for business reasons (for example, to obtain limited liability), but would prefer not to have corporate tax treatment. The noncorporate tax treatment may be preferred where the owners wish to have corporate losses pass through to their individual returns (or where most of the owners are taxed at individual income tax rates which are lower than the applicable corporate rate). Alternatively, even if the owners are taxed at individual rates higher than the corporate rate, they may prefer noncorporate tax treatment—assuming they expect to withdraw amounts of the income from the business—in order to avoid the dividend tax on corporate distributions. With the reduction of the maximum individual rate to 50 percent, beginning in 1982, more corporations will find subchapter S treatment attractive.

In light of these considerations, the Congress enacted subchapter S to minimize the effect of Federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels.

Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in tax treatment under the partnership provisions (subchapter K) and the subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership, while the subchapter S provisions do not provide such a passthrough (except for capital gains). Under the partnership provision, a distribution that does not exceed a partner's basis in his or her partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his or her partnership interest as of the close of the year; in the comparable subchapter S situation, no loss carryover is available.

The experience of taxpayers with subchapter S attests to many "traps" for those not knowledgeable about its technical provisions. These unintended adverse tax consequences most often involve (1) unintentional violation of the continuing eligibility rules, resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder's having an insufficient basis to absorb his or her share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The history of subchapter S also indicates that knowledgeable taxpayers may have derived some unintended benefits from the subchapter S provisions. Examples of such benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders, and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

The committee's bill continues the ability of small business corporations to elect a single level shareholder tax on the corporate earnings and encourages the use of these rules by eliminating unnecessary traps that exist under present law. Also, the bill tries to prevent unwarranted benefits from arising by reason of a subchapter S election.

The committee believes that partnership-like rules which pass items of income and loss through to the corporation's shareholders, with distributions being generally a return of the shareholder's investment including previously taxed earnings, is a simpler and more rational taxing scheme than the modified corporate rules of present subchapter S. Therefore, the bill adopts a partnership approach which treats all items, including such items as depletion, foreign income and fringe benefits generally like they are treated under the partnership provisions.

The committee believes that corporations should continue to be allowed to elect subchapter S without the imposition of a tax which would normally apply if the corporation liquidated and continued business as a partnership. However, in order to prevent a "bail out" of undistributed corporate earnings and profits, the bill will continue dividend treatment for distributions of these earnings. Also the passive income test (as modified) is retained for corporations with accumulated earnings and profits to prevent the conversion of a regular corporation's operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on accumulated corporate earnings as would occur if the corporation was liquidated. However, to reduce the likelihood of a termination of election, the bill, rather than terminating the election, would impose a corporate level tax in certain circumstances where the test is not met.

III. EXPLANATION OF THE BILL

A. Eligibility for Subchapter S Treatment

Present Law

Under present law, a corporation is eligible to elect and continue subchapter S status only if it (i) has no more than 25 shareholders,[1] (ii) has no shareholder other than an individual who is a citizen or resident of the United States, an estate, or certain types of trusts[2] (grantor trusts, voting trusts, testamentary trusts for a 60-day period, and certain "qualified subchapter S trusts"), (iii) is not a member of an "affiliated group" of corporations, and (iv) has only one class of stock.

Under present law, the courts have ruled that certain purported debt instruments are permissible where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes. (e.g., *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein). The Internal Revenue Service has announced that it will not litigate cases factually similar to the facts in those cases. (TIR–1248 (July 27, 1973).) In addition, under present law, a subchapter S corporation may have outstanding options and warrants to acquire stock, or debentures that are convertible into stock (Rev. Rul. 67–269, 1967–2 C.B. 298).

Explanation of Provisions

1. Permitted number of shareholders (sec. 1361(b)(1)(A))[3]

The number of permitted shareholders will be increased from 25 to 35. This number corresponds to the private placement exemption under Federal securities law.[4]

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[1] The maximum number was set at 10 when subchapter S was enacted and was increased to 15 for certain corportations by the Tax Reform Act of 1976. The Revenue Act of 1978 set the limit at 15 for all corporations. The Economic Recovery Tax Act of 1981 increased the limit to 25.

For purposes of determining the number of shareholders, a husband and wife are treated as one shareholder.

[2] Trusts were not eligible to be shareholders under subchapter S, as enacted. Voting trusts, grantor trusts, and testamentary trusts became eligible shareholders under the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 permitted as shareholders, trusts to which sec. 678 applies (under which a person other than the grantor is treated as the owner), and "qualified subchapter S trusts" (i.e., certain trusts in which the income beneficiary elects to be taxed, as the owner).

[3] References are to sections of the Internal Revenue Code of 1954 as proposed to be amended by the bill.

[4] Rule 506 of Regulation D issued pursuant to sec. 4(2) of the Securities Act of 1933.

2. One class of stock requirement (secs. 1361(b)(1)(D) and (c)(4))

The outstanding shares of the corporation must continue to be identical as to the rights of the holders in the profits and in the assets of the corporation. However, unlike present law, differences in voting rights among shares of common stock will be permitted by the bill.

In order to insure that the corporation's election will not terminate in certain situations where the existence of a purported debt instrument (that otherwise would be classified as stock) may not lead to tax avoidance and does not cause undue complexity, the bill provides that an instrument which is straight debt will not be treated as a second class of stock (within the meaning of sec. 1361(b)(1)(D)), and therefore cannot disqualify a subchapter S election. For this purpose, a straight debt instrument means a written unconditional promise to pay on demand or on a specified date a sum certain in money so long as the interest rate, and payment date are fixed. For this purpose these factors are fixed if they are not contingent on the profits of the corporation, the discretion of the corporation, or other similar factors. However, the fact that the interest rate is dependent upon the prime rate or a similar factor not related to the debtor corporation will not disqualify the instrument from being treated under the safe harbor. In order for the "safe harbor" to apply, the instrument must not be convertible into stock, and must be held by a person eligible to hold subchapter S stock.

Because a safe harbor debt instrument may nevertheless be treated as stock under general tax principles, the Secretary of the Treasury or his delegate may prescribe rules or regulations relating to the treatment of these instruments for purposes of applying subchapter S and other provisions of the Code. It is intended that these rules will treat the instrument in such a way as to prevent tax avoidance, on the one hand, and also to prevent unfair, harsh results to the taxpayer. It is anticipated that these safe-harbor instruments will be treated as debt under subchapter S, so that no corporate income or loss will be allocated to the instruments. Payments on the instruments shall be includible in the income of the holder and deductible by the corporation (subject to the rules added by the bill relating to the accrual of unpaid amounts). Payments on these instruments may be examined to determine whether the payments represent interest or other income in any situation where the treatment as interest might give the taxpayer an unwarranted tax advantage, such as under the net interest exclusion.

In the case of a regular corporation (with a straight debt instrument outstanding which is treated as stock under corporate tax law principles) that elects subchapter S, it is intended that the election not be treated as an exchange of debt for stock, but a later redemption of the instrument may be treated as a dividend if the corporation had remaining accumulated earnings and profits. Prior to the issuance of final regulations, it is intended that these general principles will apply to straight debt instruments.

The classification of an instrument outside the safe harbor rules as stock or debt will be made under usual tax law classification principals.

3. Affiliated groups (secs. 1361(b)(2)(A) and (c)(5))

The bill retains the rule that a member of an affiliated group of corporations is not eligible for subchapter S status. Thus, an electing corporation cannot own 80 percent or more of the stock of another corporation (unless the other corporation has not begun business and has no taxable income).

The bill provides that this rule applies to the holding of any subsidiary, whether or not the corporation is eligible to file a consolidated return with its subsidiary. Thus, a corporation holding a foreign corporation or a DISC as a subsidiary will be ineligible for subchapter S treatment. However, in the case of a corporation which was a subchapter S corporation on September 28, 1982, and held a foreign corporation or DISC as a subsidiary on that date, the election will remain in effect until otherwise terminated, or more than one-half of the stock has been transferred (other than by reason of death).

4. Eligible shareholders (secs. 1361(b)(1)(B), (c)(2), (c)(3) and (d))

Present law is generally retained. Only individuals (other than nonresident aliens), estates, and certain trusts will be eligible to hold stock in the corporation. Foreign trusts, like foreign corporations and nonresident aliens, will not be eligible shareholders. The committee intends that the qualified trust rules will apply to a usufruct under the principles applicable to a trust.

The bill provides that, in the case of a qualified subchapter S trust, the terms of the trust instrument only need require that there be a single income beneficiary during the life of the current income beneficiary. Thus, the possibility of multiple beneficiaries after the death of the current beneficiary will not disqualify the trust during the current beneficiary's lifetime. The bill also provides that, if a qualified subchapter S trust ceases to qualify because of the death of an income beneficiary, the trust will continue to be an eligible shareholder for the 60-day period following the death of the current beneficiary (sec. 1361(c)(2)(ii)).

Finally, the bill provides that if the trust continues to qualify after the death of the first income beneficiary, any subsequent income beneficiary will be deemed to have made the election to be taxed under section 678 unless the beneficiary affirmatively refuses to consent to the election.

5. Ineligible corporations (sec. 1361(b)(2))

Financial institutions which are allowed a deduction for bad debts under section 585 or 593, and insurance companies subject to tax under the special insurance company rules of the Code, cannot elect subchapter S.[5] These corporations are entitled to certain deductions not generally allowed to individuals. Many of these corporations are not eligible for subchapter S treatment under present law because of the passive income rules.

Possession corporations, DISC's and former DISC's will continue to be ineligible to elect subchapter S.

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[5] The Internal Revenue Service has ruled that life insurance companies may not qualify as subchapter S corporations under present law (Rev. Rul. 74-344, 1974-2 C.B. 273). The Service has also ruled that stock casualty insurance companies taxable under sec. 831(a) may elect subchapter S treatment (Rev. Rul. 74-437, 1974-2 C.B. 274).

B. Election, Revocation, and Termination

Present Law

Under present law, an election to be taxed as a subchapter S corporation may be made for any taxable year at any time during the preceding taxable year or at any time during the first 75 days of the taxable year. An election continues in effect for subsequent taxable years until it is terminated.

In order for an election to be effective, each shareholder on the day the election is made must consent to the election. If a subchapter S election is terminated, a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective, unless the Internal Revenue Service consents to an earlier election.

Under present law, the termination of an election is generally retroactive to the first day of the taxable year in which the terminating event occurred. A termination automatically occurs if the corporation fails to meet any of the eligibility requirements for subchapter S treatment. An election also terminates if all the shareholders of the corporation consent to a revocation. A revocation generally is effective for the following taxable year. Finally, an election can be terminated if a new shareholder affirmatively refuses to consent to the election on or before the 60th day after he or she acquired the stock.

A valid subchapter S election will be terminated if more than 80 percent of the corporation's gross receipts for any taxable year are derived from sources outside the United States, or if more than 20 percent of the gross receipts for any taxable year consist of royalties, rents, interests, dividends, annuities, or gain on the sale or exchange of stock or securities.

Explanation of Provisions

1. Making an election (sec. 1362 (a) and (b))

An election made on or before the fifteenth day of the third month of a corporation's taxable year will be effective beginning with the year when made if the corporation meets all the eligibility requirements (including shareholder eligibility requirements) for the pre-election portion of the taxable year, and if all persons who held stock in the corporation at any time during the portion of the year before the election was made, consent to the election.[6]

If the eligibility requirements are not met for the entire pre-election portion of the year for which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the fifteenth

[6] It is intended that the provisions of Treasury regulation § 1.1372-3(c), allowing the extension of time to file consents, will continue to apply.

day of the third month of the year, the election will not become effective until the following taxable year. This rule will prevent any allocation of income and loss to pre-election stockholders who either were ineligible to hold subchapter S corporation stock or did not consent to the election.

2. Termination of election (secs. 1362(d), (e), and (g))

Generally, specific events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation will result in a termination of the election as of the date on which the event occurred (rather than as of the first day of the taxable year, as under present law). The events causing disqualification will be: (1) exceeding the maximum allowable number of shareholders; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The day before the day on which the terminating event occurs will be treated as the last day of a short subchapter S taxable year, and the day on which the terminating event occurs will be treated as the first day of a short regular (i.e., subchapter C) taxable year. There will be no requirement that the books of a corporation be closed as of the termination date. Instead the corporation will allocate the income or loss for the entire year (i.e., both short years) on a proration basis.

The corporation can elect, with the consent of all persons who were shareholders at any time during the year, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers). Under this method, items will be attributed to the short subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in such records.

The short subchapter S and subchapter C taxable years will be treated as one year for purposes of carrying over previous subchapter C losses. The income allocated to the subchapter C taxable year will be subject to annualization for purposes of applying the corporate rate brackets. The return for the short subchapter S year will be due on the same date as the return for the short subchapter C year is due.

As under present law, if a corporation's election terminates because the passive income limitation (to the extent still applicable) is violated for any taxable year, the election is terminated for that entire taxable year.

If an election is terminated, a new election cannot be made, without the consent of the Internal Revenue Service, for 5 taxable years, as under present law. However, the 5-year waiting period will not apply with respect to terminations under the present subchapter S rules.

3. Revocation of election (sec. 1362(d)(1))

An election can be revoked only by action of shareholders holding more than one-half of the corporation's voting stock.

The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year will be modified. Under the bill, a revocation filed up to and including the fifteenth day of the third month of the taxable year will be

effective for the entire taxable year, unless a prospective effective date is specified. The period during which a retroactive revocation can be filed thus will correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year will be effective on the first day of the following taxable year unless the revocation states some other prospective date, in which case it will be effective as of the specified date.

Revocations which designate a prospective effective date will result in the splitting of the year into short subchapter S and subchapter C taxable years with the tax consequences as discussed above in connection with terminations.

A person becoming a shareholder of a subchapter S corporation after the initial election will not have the power to terminate the election by affirmatively refusing to consent to the election (unless that person owns more than one-half the voting stock). He or she will be bound by the initial election.

4. Source of income (secs. 1361(b)(2) and 1362(d)(3) and (4))

The provision of present law that a subchapter S corporation may not derive more than 80 percent of its gross receipts from sources outside the United States will be repealed.

The bill will repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income for corporations without subchapter C accumulated earnings and profits at the end of the taxable year.

For corporations with accumulated earnings and profits from years in which the corporation was a regular subchapter C corporation, a tax will be imposed on the passive income in excess of 25 percent of the gross receipts (see below). If a corporation with these earnings and profits exceeds the 25-percent limit for 3 consecutive taxable years, the election is terminated beginning with the following taxable year.

The passive income test is modified to exclude interest on deferred payment sales of property held for sale to customers (within the meaning of sec. 1221(1)) made by the corporation, and income from the conduct of a lending or finance business (as defined in sec. 542(c)(6)). In order to prevent the "churning" of assets, only the net gain from the disposition of capital assets (other than stock and securities) is taken into account in computing gross receipts.

5. Inadvertent terminations secs. 1362(f))

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no

earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

C. Treatment of Income, Deductions, and Credits

Present Law

Under present law, a subchapter S corporation is not subject to the corporate income tax. An exception to this rule is the imposition of a capital gains tax on certain subchapter S corporations, in order to discourage the making of a "one-shot" subchapter S election.

Instead, the undistributed taxable income of the corporation is includible in gross income of the shareholders owning stock on the last day of the corporation's taxable year. Similar rules pass through the credits of the corporation to its shareholders. Any net operating loss of the corporation is passed through to the shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items (such as charitable contributions), other than the long-term capital gain portion of income, do not pass through.

Income may be reallocated by the Internal Revenue Service among shareholders who are family members as necessary to reflect the value of services rendered.

A shareholder may deduct a loss only to the extent of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. Losses in excess of this limitation may not be carried over.

A shareholder's basis in the stock of the corporation is increased by the amount of undistributed taxable income taken into account, and decreased by the shareholder's share of the net operating loss passed through. Losses reduce basis in any indebtedness after the stock basis has been reduced to zero.

Explanation of Provisions

1. Taxation of corporation (secs. 1363(a), 1371(d), 1374, and 1375)

As under present law, a subchapter S corporation will not be subject to the corporate income tax, except for the present tax on capital gains. This tax, which is imposed to limit use of subchapter S on a temporary basis in order to pass capital gains through to shareholders, will continue.

Under the bill, the tax imposed under section 47 in the case of an early disposition of property will be imposed on the corporation with respect to credits allowed to the corporation prior to the effective date of the subchapter S election. The election will not be treated as a disposition of the property by the corporation.

Finally, a tax will be imposed on the excess passive income of subchapter S corporations with accumulated earnings and profits from subchapter C years. This tax will be at the highest corporate rate (presently 46 percent) on that portion of the corporation's net passive in-

come which bears the same ratio to the total net passive income for the taxable year as the excess gross passive income (i.e., gross passive income in excess of 25 percent of gross receipts) bears to the total gross passive income for the year. The amount subject to tax cannot exceed the corporation's taxable income. Net passive income means passive income less the deductions allowable under this chapter which are directly connected with the production of such income. Nonrefundable credits are not allowed against this tax. Any gain subject to tax under this section will not be subject to tax under section 1374. The amount of tax under this section will reduce the amount of items the shareholder must take into income.

2. Treatment of shareholders (secs. 1363(b) and (c), 1366, 1367, 1371(b) and 1373)

In general

The bill sets forth new rules for the taxation of income earned by, and the allowance of losses incurred by, subchapter S corporations. These rules generally follow the present law rules governing the taxation of partners with respect to items of partnership income and loss.

Computation of corporate items

A subchapter S corporation's taxable income will be computed under the same rules presently applicable to partnerships under section 703, except that the amortization of organization expenditures under section 248 will be an allowable deduction. As in the case of partnerships, deductions generally allowable to individuals will be allowed to subchapter S corporations, but provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction (sec. 243) or the special rules relating to corporate tax preferences (sec. 291), will not apply. Items, the separate treatment which could affect the liability of any shareholder (such as investment interest) will be treated separately. Elections will generally be made at the corporate level, except for those elections which the partners of a partnership may make separately (such as the election to claim the foreign tax credit).

Generally subchapter C will apply, except that a subchapter S corporation will be treated in the same manner as an individual in transactions, such as the treatment of dividends received under section 301, where the corporation is a shareholder in a regular corporation. Provisions relating to transactions by a subchapter S corporation with respect to its own stock will be treated as if the S corporation were a regular corporation. However, the subchapter C rules are not to apply where the result would be inconsistent with the purpose of the subchapter S rules which treat the corporation as a passthrough entity.

Passthrough of items

The following examples illustrate the operation of the bill's passthrough rules:

a. *Capital gains and losses.*—Gains or losses from sales or exchanges of capital assets will pass through to the shareholders as capital gains or losses. Net capital gains will no longer be offset by ordinary losses at the corporate level.

b. *Section 1231 gains and losses.*—The gains and losses on certain property used in a trade or business will be passed through separately and will be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains will no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

c. *Charitable contributions.*—The corporate 10-percent limitation will no longer apply to contributions by the corporation. As in the case of partnerships, the contributions will pass through to the shareholders, at which level they will be subject to the individual limitations on deductibility.

d. *Tax-exempt interest.*—Tax-exempt interest will pass through to the shareholders as such and will increase the shareholders' basis in their subchapter S stock. Subsequent distributions by a corporation will not result in taxation of the tax-exempt income. (See discussion below for rules relating to corporate distributions.)

e. *Foreign tax credit.*—Foreign taxes paid by the corporation will pass through as such to the shareholders, who will claim such taxes either as deductions or credits (subject to the applicable limitations). A subchapter S corporation will not be eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the subchapter S corporation is a shareholder; therefore, these taxes will not pass through to its shareholders. The special foreign loss recapture provisions (section 904(f)) will apply to a corporation electing out of subchapter S which had previously passed foreign losses through to its shareholders. Rules concerning the source of income, including the capital gains source rule (section 904(b)), and the amount of creditable taxes, such as the oil and gas foreign tax credit rules (section 907(a)), will apply at the shareholder level.

f. *Credits.*—As with partnerships, items involved in the determination of credits, such as the basis of section 38 property for purposes of computing the amount of qualified investment eligible for the investment tax credit, will pass through to the subchapter S corporation's shareholders.

g. *Depletion.*—The present rules governing depletion with regard to partnership interests in minerals will apply to depletion of properties of a subchapter S corporation (see discussion below for special rules in the case of oil and gas properties).

h. *Foreign income and loss.*—Domestic losses and foreign losses will pass through separately. If a corporation had foreign losses and domestic income, or vice versa, each will pass through separately to shareholders without aggregation at the corporate level.

i. *Other items.*—Limitations on the used property investment tax credit (sec. 48(c)), the expensing of certain depreciable business assets (sec. 179), and the amortization of reforestation expenditures (sec. 194) will apply at both the corporate level and shareholder level, as in the case of partnerships. Exclusions of income from discharge of indebtedness will be determined at the shareholder level (sec. 108). The election to capitalize intangible costs by a shareholder who does not actively participate in the

management of the corporation will be the same as the election by a limited partner, i.e. 10 year amortization (sec. 58(i)). The subchapter S corporation will be treated as a middleman with respect to the withholding on payment of interest and dividends it receives (sec. 3453).

Carryovers from years in which the corporation was not a subchapter S corporation will not be allowed to the corporation while in subchapter S status.

Shareholders treatment of items

In general.—As with the partners of a partnership, each shareholder of a subchapter S corporation will take into account separately his or her pro rate share of items of income, deduction, credit, etc., of the corporation. These rules parallel the partnership rules under section 702.

Each shareholder's share of the items will be taken into account in the shareholder's taxable year in which the corporation's year ends. In the case of the death of a shareholder, the shareholder's portion of subchapter S items will be taken into account on the shareholder's final income tax return. Items from the portion of the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.

For these purposes, a shareholder's pro rata share generally will be determined in the same manner as the present law rule for passing through net operating losses. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits will be allocated in essentially the same manner as when the election terminates during the year. Thus, the allocation generally will be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permanent records (including work papers).

A "conduit" rule for determining the character of items realized by the corporation and included in the shareholder's pro rata share will be the same as the partnership rule (sec. 702(b)). Under the partnership rules, this has generally resulted in an entity level characterization. Also, the "gross income" determinations made by a shareholder will parallel the partnership rule (sec. 702(c)).

Worthless stock.—If the corporation's stock becomes worthless in any taxable year of the corporation or shareholder, the corporate items for that year will be taken into account by the shareholders and the adjustments to the stock's basis will be made before the stock's worthlessness is taken into account under section 165(g).

Family members.—Under the bill, items taken into account by members of the family (whether or not themselves shareholders) wherever it is necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation may be properly adjusted. Both the amount of compensation and the timing of the compensation can be so adjusted.

Loss limitations.—As under present law, a shareholder's allowable pro rata share of the corporation's loss will be limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation

to the shareholder. However, unlike present law, disallowed losses can be carried forward or allowed in any subsequent year in which the shareholder has adequate basis in such stock or debt.

Foreign losses.—For purposes of computing the amount of foreign losses that must be recaptured under the foreign tax credit rules (section 904(f)), the making or termination of an election to be treated as an S corporation shall be treated as the disposition of a business. Accordingly, when an S election is made, the corporation will be treated as having disposed of its foreign property and will include in income the amount of any foreign losses not previously recaptured. Likewise, when an S election is terminated, the shareholders will be treated as if the corporation disposed of its foreign assets, and the shareholders will include in income the amount of any foreign losses of the corporation previously passed through to them and not previously recaptured.

Terminated election.—Subsequent to a termination of a subchapter S election, these disallowed losses will be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates:

(1) One year after the effective date of the termination, or the due date for the last subchapter S return, whichever is later; or

(2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. (A determination will be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the Internal Revenue Service that the corporation failed to qualify.)

3. Basis adjustment (sec. 1367)

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses will serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation. These rules generally will be analogous to those provided for partnerships under section 705. Under these rules, income and loss for any corporate taxable year will apply to adjust basis before the distribution rules apply for that year. Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis will be reduced by the fair market value of these properties (see below). Any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) will first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

D. Treatment of Corporate Distributions

Present Law

Under present law, the general rules applicable to distributions to shareholders by regular corporations apply to such distributions by subchapter S corporations. Under the normal corporate rules, distributions of money or other property are treated as taxable dividends, at fair market value, to the extent the corporation has either current or accumulated earnings and profits. Distributions in excess of earnings and profits are tax-free up to the shareholder's basis in the stock, and any excess is then treated as gain from the sale of the stock.

In addition to the regular rules, special rules also apply to distributions by subchapter S corporations. These rules allow a corporation to make tax-free cash distributions within 2½ months after the close of the taxable year out of the prior year's undistributed taxable income to the extent of the shareholder's portion of that income (sec. 1375(f)). Also, cash distributions which are not distributions of the prior year's undistributed taxable income and which are in excess of current earnings and profits qualify as tax-free distributions of a shareholder's previously taxed income to the extent of that income (sec. 1375(d)). The right to receive previously taxed income is not transferable and terminates when the corporation's subchapter S election terminates.

Property distributions by subchapter S corporations are treated differently from cash distributions in that they do not reduce the amount of the current year's undistributed taxable income taxed to the shareholder and do not qualify as distributions of either undistributed taxable income or of previously taxed income. Also, property distributions reduce earnings and profits by an amount equal to the adjusted basis of the property distributed.

In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income (a special rule reverses the order of items (2) and (3) in the case of certain accelerated depreciation); (4) a dividend to the extent of accumulated earnings and profits (the shareholder may elect to reverse the order of items (3) and (4)); (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.

Property distributions have the following tax consequences under present law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock.

Generally, distributions have no tax effect on the distributing corporation, except for distributions of LIFO inventory where the "LIFO reserve" is recaptured, or distributions of property where the liability exceeds basis, which results in gain to the extent of the excess (sec. 311 (a), (b), and (c)).

Explanation of Provisions

1. Taxation of shareholders (secs. 1368 and 1371(c))

Under the bill, the amount of any distribution to a shareholder will equal the amount of cash distributed plus the fair market value of any property distributed, as under present law.

The amount of a distribution by a corporation without accumulated earnings and profits will be tax-free to the extent of the shareholder's basis in the stock. The distribution will be applied to reduce the shareholder's basis in his stock. To the extent the amount of the distribution exceeds basis, capital gains generally will result.

No post-1982 earnings of a subchapter S corporation will be considered earnings and profits for this purpose. Thus, under the bill, a corporation will not have earnings and profits attributable to any taxable year beginning after 1982 if a subchapter S election was in effect for that year. However, a corporation can have earnings and profits attributable to (1) taxable years for which an election was not in effect, (2) taxable years beginning prior to 1983 for which an election was in effect, and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

A distribution by a subchapter S corporation with accumulated earnings and profits will be treated as if made by a subchapter S corporation with no earnings and profits up to the amount in the corporation's accumulated adjustment account (i.e., post-1982 accumulated gross income less deductible expenses, not previously distributed). Any excess will then be treated as a dividend up to the amount of accumulated earnings and profits; any residual amount will then be applied against the shareholder's remaining basis in his stock; and, finally, any remainder of the distribution generally will be treated as capital gain.

Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits will be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.

The rules described above will apply to the transferee of stock in a subchapter S corporation regardless of the manner in which the transferee acquires the stock.

2. Treatment of corporation (sec. 1363(d))

Gain will be recognized by a subchapter S corporation on a distribution of appreciated property, other than distributions in complete liquidation of the corporation, in the same manner as if the property had been sold to the shareholder at its fair market value. Like other corporate gain, it will pass-thru to the shareholders.

Without this rule, assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis.

E. Taxable Year of Corporation

Present Law

Under present law, shareholders of a subchapter S corporation take into account undistributed taxable income and net operating losses for their taxable years in which the subchapter S taxable year ends. No special rules limit the taxable year which the corporation may select. As a result, a deferral of tax can result if a taxable year ending after the end of the shareholder's taxable year is selected.

Explanation of Provision (sec. 1378)

Under the bill, the taxable year of a subchapter S corporation will be required to be either a year ending December 31, or any other table year for which it establishes a business purpose to the satisfaction of the Internal Revenue Service.

A corporation which is a subchapter S corporation during the taxable year which includes December 31, 1982, will be permitted to retain its existing taxable year so long as at least 50 percent of the stock in the corporation is owned by the same persons who owned such stock on December 31, 1982. However, to retain subchapter S status for taxable years beginning after the day on which more than 50 percent of its stock have changed ownership subsequent to December 31, 1982, the corporation will have to conform to the general taxable year rule and either use the calendar year or establish a business purpose for a different year. For these purposes, transfers of shares to family members (within the meaning of sec. 267(c)(4)) or by reason of the shareholder's death will not be considered changes in ownership.

Also, transfers to a family member pursuant to a buy-sell agreement in effect on September 28, 1982, and at all times thereafter, will not be considered as a change in ownership, where the agreement provides that on the death of any party to the agreement, the stock held by such party will be sold to surviving parties to such agreement (who were parties on September 28, 1982).

F. Other Rules

1. Treatment of fringe benefits

Present Law

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of subchapter C corporations. The benefits include the following:

(1) the $5,000 death benefit exclusion (sec. 101(b));
(2) the exclusion from income of amounts paid for an accident and health plan (secs. 105 (b), (c), and (d));
(3) the exclusion from income of amounts paid by an employer to an accident and health plan (sec. 106);
(4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79); and
(5) the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

Explanation of Provision (sec. 1372)

Under the bill, the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation will be treated in the same manner as a partner in a partnership. Thus, for example, amounts paid for the medical care of a shareholder-employee will not be deductible by the corporation (by reason of secs. 1363 (b)(2) and 703(a)(2)(E)), will be deductible by that individual only to the extent personal medical expenses will be allowed as an itemized deduction under section 213. However, similar amounts paid by the corporation on behalf of shareholders owning two percent or less of the corporation may be deducted as a business expense.

2. Treatment of oil and gas production

Present Law

Under present law, the allowance for depletion, including depletion with respect to oil and gas wells, for a subchapter S corporation, is computed by the corporation and taken into account in determining the taxable income of the subchapter S corporation. The depletion deductions taken into account in determining earnings and profits of a subchapter S corporation are computed based on cost depletion. Thus, when a subchapter S corporation claims percentage depletion, it may generate current earnings and profits in excess of taxable income, and amounts distributed in excess of taxable income may be taxed as a dividend to the shareholders.

The right to claim percentage depletion with respect to oil and gas wells is limited under present law to certain independent producers and royalty owners. To prevent a proliferation of interests eligible for percentage depletion, present law provides anti-transfer rules which limit the ability of transferees to claim percentage depletion on production attributable to an interest in proven oil or gas properties transferred after 1974. Generally, a transfer from an individual to a subchapter S corporation will result in the loss of percentage depletion unless the special rules provided in section 613A(c)(10) are satisfied. In essence, these rules require that the corporation's stock be issued solely in exchange for oil and gas properties and that there be an allocation of the barrel-per-day limitation on percentage depletion between the corporation and the individuals contributing the property. Similarly, the transfer of an oil and gas property from the subchapter S corporation to one or more of the shareholders will result in the loss of percentage depletion for production from the transferred property. However, the subchapter S election by a regular corporation is not treated as a transfer (Rev. Rul. 80–43, 1980–1 C.B. 133).

Under present law, the windfall profit tax is imposed upon the producer of domestic crude oil. In the case of a subchapter S corporation, the producer of crude oil is the corporation and not the individual shareholders. The transfer of property from or to a corporation would be a transfer resulting in the loss of lower rates on production by independent producers, unless one of the specified exceptions to the anti-transfer rules applied.

Explanation of Provisions (secs. 613A, 4992 and 4996)

Under the bill, the allowance for depletion in the case of oil and gas properties held by a subchapter S corporation will be computed in a manner similar to that used in the computation of depletion in the case of partnerships. Specifically, the percentage or cost depletion allowance will be available directly to the shareholders of the subchapter S corporation and will be computed separately by each individual shareholder. Each shareholder will be treated as having produced his or her pro rata share of the production of the subchapter S corporation and each shareholder will be allocated his or her respective share of the adjusted basis of the subchapter S corporation in each oil or gas property held by the corporation.

For purposes of applying the anti-transfer rules in the percentage depletion provisions, the subchapter S corporation will be treated as a partnership and the shareholders will be treated as partners. Similarly, an election by a regular corporation to become a subchapter S corporation will be treated as a transfer of all the property of the corporation effective on the day on which the election takes effect. Finally, for purposes of the anti-transfer rules, the termination of a subchapter S election and the reversion to regular status will be treated as a transfer by the shareholders of all the assets of the subchapter S corporation to the regular corporation.

For purposes of the windfall profit tax, a subchapter S corporation will be treated as a partnership. Specifically, any subchapter S corporation which would otherwise be treated as a producer of crude oil will

not be so treated; instead, all the crude oil produced by that corporation will be allocated among the shareholders in proportion to each shareholder's pro rata share of the income of the corporation. Each shareholder entitled to an allocation of crude oil will be treated as the producer of that crude oil for purposes of the windfall profit tax. Thus, for purposes of the independent producer lower rates (including the anti-transfer rules), the subchapter S corporation will be treated as a partnership and the shareholders of the subchapter S corporation will be treated as partners of a partnership.

3. Treatment of expenses owed to shareholders

Present Law

Under present law, a subchapter C corporation, in order to obtain a deduction for business expenses or interest payable to a cash-basis shareholder owning (after application of the constructive ownership rules of sec. 267(c)) more than 50 percent of the stock of the corporation, must actually pay such items not later than 2½ months after the close of its taxable year. If the shareholder owns 50 percent or less of the stock, a subchapter S corporation on the accrual method of accounting may accrue the deduction (to the extent otherwise allowable) notwithstanding that the shareholder does not include the amount in income until actually paid.

Explanation of Provision (sec. 267)

The bill places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer, including a shareholder who owns at least two percent of the stock in the corporation. (The committee wishes to clarify that the provision applies only where the recipient uses the cash method of accounting and would not apply, for example, where the recipient uses the completed-contract method of accounting.) Thus, the timing of the corporation's deductions (which are taken into account on the shareholders' returns) and the shareholder's income will match. Also, no deductions will be lost if payment is made after 2½-month period expires.

The usual loss disallowance rules (of sec. 267(a)(1)) will apply to transactions between two subchapter S corporations or between a subchapter S corporation and a partnership, if both entities are more than 50 percent owned by the same persons. Also a subchapter S corporation and a regular operation are treated as related if the same individual owns more than 50 percent of the value of the outstanding stock in each corporation.

G. Tax Administration Provisions

Present Law

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

Explanation of Provision (secs. 6241–6245)

Under the bill, the tax treatment of items of subchapter S income, loss, deductions, and credits generally will be determined at the corporate level in a unified proceeding rather than in separate proceedings with shareholders. Shareholders will be given notice of any administrative or judicial proceeding at which such items will be determined. Further, each shareholder will be given the opportunity to participate in these proceedings. Shareholders will be required to file returns consistent with the corporate return or notify the Internal Revenue Service of the inconsistency.

The audit provisions are to generally follow the new audit provisions made applicable to partnerships by the Tax Equity and Fiscal Responsibility Act of 1982. Thus, for example, rules relating to restrictions on assessing deficiencies, periods of limitations, and judicial review will follow the corresponding partnership rules. However, those rules may be modified by Treasury regulations where appropriate to take account of the differences (whether or not tax related) between a corporation and a partnership. For example, the selection of a person to act on behalf of the corporation in the way the tax matters partner acts on behalf of a partnership must take into account that a corporation has no person to correspond to a general partner, as such (since the corporate shareholders are not liable for the corporation's debts, as is a general partner). As with partnerships, the regulations may treat certain corporate items as other than corporate items, for purposes of these audit rules, where special enforcement problems arise.

H. Effective Date and Transitional Rules (sec. 1379)

The bill will apply to taxable years beginning after December 31, 1982. Existing subchapter S corporations will be treated under the new rules for the first taxable year beginning after that date. Pre-enactment undistributed taxable income and previously taxed income of these corporations can be distributed in the future under the rules of present law. Carryforwards, such as capital loss carryforwards and charitable contribution carryovers from the corporation's last pre-enactment year shall be treated as sustained in it's first post-enactment year.

The present rules of section 1379, relating to pension and profit-sharing plans, will continue in effect for years beginning before 1984. Also the amendment relating to certain death benefit payments made by section 239 of the Tax Equity and Fiscal Responsibility Act of 1982 will apply, in the case of subchapter S corporations, after 1982.

The new passive income rules (and not the rules of present law) will apply to taxable years beginning after December 31, 1981.

The amendments to subchapter S made by the bill will not apply to a casualty insurance company described in section 831 (a) if either (1) the corporation was a subchapter S casualty insurance company on July 12, 1982, (2) the corporation was formed prior to April 1, 1982, and proposed, through a written private offering first circulated to investors prior to that date, to elect to be taxed as a subchapter S corporation and to be operated on an established insurance exchange; or (3) the corporation is approved for membership on an established insurance exchange pursuant to a written agreement entered into before December 31, 1982, and the corporation is engaged in the casualty insurance business before the end of 1984. These corporations will continue under present subchapter S rules until either the subchapter S election is terminated, or more than one-half the stock ceases (other than by reason of death) to be held by persons holding the stock on December 31, 1984. It is not intended that this provision will allow corporations to be set up as "shelf corporations" by the end of 1982 in order to find investors in the future.

Existing subchapter S corporations can retain existing fringe benefits for taxable years beginning through 1987, so long as the present law passive income test is not violated, the election does not terminate and a majority of the stock is not transferred.

An existing subchapter S corporation whose average daily production of domestic crude oil or natural gas in combination with a 40-percent shareholder's production, exceeds 1,000 barrels may elect to have the rules of present subchapter S apply rather than the rules added by this bill. This also applies to small business corporations filing an election before September 28, 1982.

IV. COSTS OF CARRYING OUT THE PROVISIONS OF THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of H.R. 6055, as reported.

The bill will result in reduction of budget receipts by less than $10 million annually.

The Treasury Department agrees with this statement. . . .

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 6055, as amended, was ordered favorably reported by voice vote.

V. REGULATORY IMPACT OF THE PROVISIONS OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of this bill, H.R. 6055 as reported.

Numbers of individuals and businesses who would be regulated

The bill does not involve new or expanded regulation of individuals or businesses.

Economic impact of regulation on individuals, consumers and businesses

The bill will make it easier for persons to operate businesses as a subchapter S corporation.

Impact on personal privacy

This bill does not relate to the personal privacy of taxpayers.

Determination of the amount of paperwork

The bill generally will not affect the current amount of paperwork for most taxpayers. The bill will simplify the application of tax rules relating to subchapter S corporations.

B. Other Matters

Consultation with Congressional Budget Office on budget estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates of the tax provisions of the bill (as shown in Section IV of this report) and agrees with the methodology used and the committee's budget estimate.

New budget authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill involves no new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill involves no new or increased tax expenditures.

VI. CHANGES IN EXISTING LAW MADE BY THE REVENUE PROVISIONS OF THE BILL AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the revenue provisions of H.R. 6055, as reported by the committee).

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